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TAGS: [ECON](#) [EAID](#) [EFIN](#) [PREL](#) [ER](#)
SUBJECT: Dire Economic Conditions Compel GSE to Court
IMF; Donors Doubt ItQs a Match That Will Last

CLASSIFIED BY: AMB Scott H. DeLisi, for reasons 1.4 (b)
and (d).

¶1. (C) Summary: After two weeks of consultation, the IMF mission team presented a hopeful image for the future as GSE officials offered assurance of GSE interest and commitment to a staff monitored program(SMP) as the first step toward HIPC support for Eritrea. GSE interest is, of course, tempered with concerns about requiring monetary policy changes such as exchange rate adjustments and opening the import market. Moreover, implementation is fraught with tension both within the GSE and between the donors and the GSE. DonorQs expressed heavy skepticism about the GSEQs commitment and about its willingness to transition to transparency. With the GSE shutting out donors and withdrawing from bilateral partnership with the US and other western nations over the past year donor skepticism is unsurprising. Still, a last chance to regain donor support for HIPC debt relief may be a powerful incentive for the GSE to reengage and consider compliance with IMF reforms. We are doubtful it will happen, but given the GSEQs dire economic situation, we expect the GSE to play out its dialogue a bit further in hope that donors may still join the IMF in saving the GSE from itself. End Summary.

COMPONENTS OF THE SMP

¶2. (C) With the sunset clause for HIPC support rapidly approaching in December 2006, the pressure is on the GSE to implement an IMF staff monitored program in hope of a full program being approved by yearQs end. IMF staff, in interim and final outbriefings with donors, reported that macroeconomic stabilization - combining fiscal adjustments with supportive monetary conditions - would be the foundation of the SMP. The SMP monthly targets will focus on: severe restrictions on domestic lending, increasing net international reserves, controlling the balance of payments, reducing government expenditures, increasing tax revenue, and reducing the fiscal deficit(primarily the domestic balance.) Measurement of these targets would need to be completed by the end of

October in order to allow the IMF time to prepare for the December board meeting. (Note: In the best case scenario (and possibly unrealistic one), presuming agreement and initiation by June 30, this would allow for 4 months of data.)

13. (C) Meeting the monthly targets is important, however, these accomplishments alone will not be enough. The SMP will also require increasing transparency in the financial sector and regarding government budgetary practices, including the publishing of a budgetary framework and dialogue with donors. The IMF expects that economic data such as the Consumer Price Index and the fiscal data of the GSE will be made available. Furthermore, the IMF requires that action plans be implemented to address such issues as weaknesses in the banking system. Finally, the IMF anticipates the World Bank funded public expenditure review on the health and education sectors will be completed in a timely manner. All of these steps, according to the IMF team leader, will demonstrate the GSE commitment to reform and show that "they [the GSE] have a vision."

TIMING IS EVERYTHING

14. (C) Of greatest concern to the GSE, according to the IMF staff, is the impact and timing of the monetary policy changes; namely devaluation of the currency and reopening/liberalization of the import market. Devaluing the currency 15 to 19 nakfa to the dollar (which is the IMF recommendation) will, with the current level of debt and without donor support, lead to greater inflation. With inflation reported to the IMF at 12%, but in reality

probably higher, the risk of inflation concerns the GSE. The GSE is also reluctant to liberalize imports, another IMF recommendation. With no exports to speak of there will be little gain on that front from devaluation which could offset the increased costs of imports. The effect on the balance of payments and international reserves will, as a result, likely be severe. (Comment: The GSE currently uses currency controls and other mechanisms to restrict private sector imports and those imports that are allowed are destined for companies controlled by government through its political party, the People's Front for Democracy and Justice. Keenly aware as well that increased economic freedom can lead to challenges to political restrictions, the government has multiple reasons to want to go slow on both devaluation and trade liberalization. If they do proceed, it will be an indication of just how dire the GSE's economic situation has become. End Comment.)

MEETING THE DEADLINE: WHAT REMAINS TO BE DONE

15. (C) According to the IMF team the GSE has agreed to these measures "in principle," however no agreement exists on the data points. What is still missing? A three year macroeconomic framework, the selection and agreement on the actual numbers for five or six fiscal benchmarks for monitoring and an action plan for interaction with stakeholders, such as civil society and the donors. Moreover, there is no agreement yet on the timing of devaluation or on what actions will be taken when in regard to trade liberalization. Although the "theory" of a staff-monitored program is agreed, the IMF team acknowledged that they departed on June 10 with a lot of oral commitments but nothing in writing.

IT ALL SOUNDS GOOD: DOES THE GSE REALLY WANT IT?

16. (C) While the IMF team leader praised the cooperation of the Ministry of National Development and Minister

WoldaiQs understanding and commitment to reform, the team leader did share with the Ambassador the reluctance of the Ministry of Finance to engage. During the first week of the visit, the Ministry of Finance, including the Minister, refused to meet with the IMF team. Reportedly, Minister Woldai traveled down to Massawa to ask President Isaias to direct the Minister of Finance to cooperate. This effort resulted in the IMF being able to obtain what it needed from the Ministry of Finance. Noting these differences within the GSE during his outbrief for donors, the IMF team leader suggested that donor support for an IMF program with the GSE might also support and strengthen the position of "the more progressive actors within the GSE." The IMF team noted as well that the GSE had indicated that without assurances of donor support there were certain steps that it could not take, including action on currency devaluation and liberalization of trade policy. Under any circumstance, however, the GSE indicated that it would, in fact, want to delay these two measures as long as possible.

WILL THE DONORS HELP?

¶17. (C) Donor response throughout the IMF teamsQ visit was widely skeptical reflecting a considerable lack of trust in the GSEQs professed commitment to reform. Many donors, especially the Dutch, also discounted the significance the IMF attached to the prospect of Minister Woldai signing an agreement with the Fund. Noting the GSEQs readiness to abrogate and completely disregard contracts and agreements regarding food aid, the Dutch Deputy Chief of Mission dismissed any signed document by the GSE as being meaningless. He also noted that his government would be unwilling to offer any sort of support until the GSE takes irreversible and solid steps

toward reform. The European Commission indicated that while donor support for an IMF program was planned for 2007 and beyond, the trust level was extremely low and the monies at this point unlikely to be released.

COMMENT

¶18. (C) Comment: We fully share the skepticism about the GSEQs willingness to ultimately proceed with an IMF staff monitored program and, if it does proceed, remain doubtful that it will ultimately enact promised reforms. Nonetheless, we are struck by the extent of the GSE engagement with the IMF and the fact that the GSE invited the Fund back for these discussions and claims to be committed in principle to a SMP has surprised us all. It may be a hopeful sign that at least on economic issues the GSE is rethinking its disastrous insistence on control. More likely, however, it reflects a growing realization for the GSE that the problems associated with high debt, virtually no exports and negligible hard currency reserves has brought the economy near collapse. If so, it may perhaps offer donors a degree of leverage with the GSE, and pledges of economic support in conjunction with efforts to reach agreement on border demarcation and normalization, could be an important incentive to elicit GSE cooperation.

¶19. (C) Comment continued. That said, we question whether the senior leadership of the GSE will ultimately accept participation in a SMP, knowing it would be tantamount to admitting they are in deep trouble. The Minister for National Development in fact, within days of the IMF teamQs departure, told one international visitor that "current conditions and national requirements" (i.e. the border conflict) would make it very difficult for the GSE to enact the required reforms. The GSE knows as well that donors -- who are still reeling from the GSEQs travel restrictions, seizure of food aid, and expulsion of many partner NGOs are likely to be reluctant to offer support absent truly meaningful reform. As a result, we

would not be surprised to see the GSE play out its dialogue with the IMF and then, when it decides the reforms are too much to accept, turn the blame on donors claiming that yet again they were abandoned by an international community that unhesitatingly provides abundant support to arch-rival Ethiopia. End Comment.

DeLisi